STAFF PAPER

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Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**		
Paper topic	Completed Contracts at Transition		
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The following implementation questions and potential interpretations were submitted to the TRG by a stakeholder.

Background

1. Under the modified retrospective transition method, entities will apply Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the "new revenue standard"), only to contracts that are not completed contracts as of the date of initial application. The new revenue standard states in subparagraph 606-10-65-1(c)(2) [C2(b)][1] that a contract is considered "completed" if the entity has transferred all of the goods or services identified in accordance with today's revenue guidance.
2. Questions have arisen regarding two aspects of this guidance:
   (a) When is a contract considered "completed" for purposes of applying the transition guidance?
   (b) How should "completed contracts" be accounted for after adoption of the new standard?
3. At the joint Board meeting held in March 2015, the IASB decided to propose adding a practical expedient that would permit an entity electing the full retrospective approach to only apply the new revenue standard retrospectively to contracts that are not

[1] IFRS 15 references are included in "[XX]" throughout this paper.

completed under today's requirements as of the beginning of the earliest period presented in the financial statements. However, the FASB voted not to add this practical expedient. Therefore, for U.S. GAAP purposes, this implementation issue only arises if an entity elects to apply the modified retrospective transition method.

4. Note that this paper focuses on the U.S. GAAP implications, but similar issues could arise under IFRS.

Accounting Guidance

5. The relevant accounting guidance has been included in Appendix A of this paper.

Implementation Issues

6. This section of the paper includes questions that have been brought to the staff's attention about completed contracts at transition. Examples have been included to facilitate discussion among members of the TRG.

Issue 1: When is a contract considered "completed" for purposes of applying the transition guidance?

7. There are some circumstances in which it is not clear whether a contract is "completed" as defined in the new revenue standard. One of the challenges in applying the guidance is that it refers to whether the entity has "transferred all of the goods or services" (a concept in the new revenue standard), but requires the assessment to be done based on current U.S. GAAP. A potential solution identified by the submitter is to define a "completed contract" as a contract for which all of the revenue has been recognized under current U.S. GAAP. This approach would be easier to apply and would eliminate many of the questions raised in this paper. However, the submitter believes this approach would require an amendment to the standard.
8. Examples of some of the more challenging fact patterns are outlined below. All examples assume the date of initial application is January 1, 2017, and the modified retrospective transition method is applied.

Example 1

9. An entity licenses intellectual property ("IP") to a customer for a three-year term in exchange for a fixed fee on January 1, 2016. There are no other explicit promises to the customer in the contract. Under current U.S. GAAP, the entity recognizes the fee ratably over the three-year term. Under the new revenue standard, revenue related to the IP would be recognized at a point in time. As of January 1, 2017, the entity has recognized one-third of the upfront fee, and the remaining balance is recorded as deferred revenue.

View A

10. The contract is considered "completed" because the entity does not have to transfer any additional goods or services. This conclusion is supported by the rationale in the new revenue standard that requires recognition of revenue at a point in time (i.e., there are no ongoing activities being performed by the licensor). The ratable recognition approach applied under current U.S. GAAP was acceptable (often by analogy to lease accounting) based on the lack of specific guidance. However, the fact that revenue has been deferred does not mean, in this instance, that there are additional goods or services to be transferred under the arrangement.

View B

11. The contract is not considered "completed," because the entity concluded under current U.S. GAAP that revenue should be recognized ratably. Because the entity has deferred revenue related to the arrangement, it must have concluded, under current U.S. GAAP, that it had not fully performed. The fact that the new revenue standard prescribes a different accounting treatment (recognition at a point in time) is not relevant to this assessment, because the assessment is based on current U.S. GAAP.

Example 2

12. An entity licenses software to a customer on January 1, 2016. There are no other explicit promises to the customer in the contract. The customer will make payments in three annual installments beginning December 31, 2016. Under current U.S. GAAP, fees are presumed to not be fixed or determinable if a significant portion of the fee is not due for more than a year after delivery. The entity does not intend to provide additional

products or a price concession to this customer, but it is unable to overcome the presumption because it does not have a history of providing extended payment terms. As of December 31, 2016, the entity has recognized revenue equal to the first installment payment. No revenue has been recognized for the remaining two payments that are not yet due. Under the new revenue standard, revenue would have been recognized on January 1, 2016 (that is, at the point in time when the customer can first use the software).

View A

13. The contract is considered "completed," because the software has been transferred to the customer, there are no other promises to the customer in the contract, and the entity does not intend to transfer any additional products to the customer.

View B

14. The contract is not considered "completed," because current U.S. GAAP presumes that the entity will make a concession in the form of a price concession or by delivering additional products. Thus, the entity has not fully performed.

Example 3

15. A retailer has a loyalty rewards program that rewards customers with points based on dollars spent. Points are redeemable for a discount off future purchases at the retailer's store. Under current U.S. GAAP, the retailer follows the incremental cost accrual model, recognizing revenue at the time of initial sale and an accrual for the expected costs of satisfying the award credits. Under the new revenue standard, the transaction price would be allocated between the product and the loyalty reward performance obligations (assuming the entity concludes the loyalty rewards program is a material right) based on relative stand-alone selling prices. The retailer sells (and immediately delivers) product to a customer on December 31, 2016, recognizes all of the revenue from the sale, and accrues the cost of satisfying the related award credits.

View A

16. The contract is considered "completed," because the retailer concluded under current U.S. GAAP that it fully performed when the product was transferred and recognized all of the related revenue at that time. In other words, the retailer did not identify the

loyalty points as a "deliverable" in accordance with current U.S. GAAP. If the retailer had identified the loyalty points as a deliverable, it would have deferred a portion of the revenue.

View B

17. The contract is not considered "completed," because the retailer still has to perform related to the loyalty points, even though current U.S. GAAP does not require deferral of revenue. The retailer's policy of applying the incremental cost accrual method (one acceptable approach under current U.S. GAAP) does not change the fact that it is committed to transfer product in the future in exchange for the loyalty points.

Issue 2: How should an entity account for "completed contracts after adoption of the new standard?

18. There are circumstances in which an entity has transferred all of the goods or services related to a contract, but the accounting for the transaction is not complete (that is, revenue might not have been recognized under current U.S. GAAP). Examples include situations in which collectibility is not probable or revenue is not fixed or determinable. In these cases, the contract meets the definition of a "completed contract," and thus, an entity would not apply the new standard to the contract under the modified retrospective transition method. However, because the accounting for the transaction is not complete, it is unclear how to account for these contracts after the adoption of the new standard.
19. One view (View A) is that an entity would continue to account for such contracts under current U.S. GAAP after adoption of the new standard. Supporters of this view believe that if the new revenue standard is not applied to a contract under the modified retrospective transition method, then, by default, the legacy revenue guidance should continue to be applied. This would result in "mixed GAAP" for a period of time until the accounting is completed for such contracts.
20. An alternative view (View B) is that an entity should not continue to account for "completed contracts" after adoption of the new revenue standard. Supporters of this view believe the new revenue standard considers such contract to be "completed" and, therefore, no revenue should be recognized related to the contract post-adoption. Any deferred revenue balances should be written-off as part of the cumulative effect adjustment. Additionally, any cash related to a "completed contract" that is collected after the adoption of the new revenue standard would not be recognized as revenue.

Supporters of this view believe the Boards did not intend for there to be a period of "mixed GAAP" after adoption of the new standard.

21. The examples included below are intended to illustrate those two views.

Example 1

22. A consumer products entity uses a distributor network to supply its product to end consumers. Under current U.S. GAAP, the entity recognizes revenue when the product is sold by the distributor to the end consumer ("sell-through approach"). The distributor is able to receive price adjustments prior to sell-through to the end customer; therefore, the price was not considered "fixed or determinable" under existing U.S. GAAP. Under the new revenue standard, the entity concludes that control transfers when the product is shipped to the distributor; thus, revenue would be recognized at that time, applying the guidance for variable consideration (including the constraint on variable consideration). The entity transfers all products included in a given contract to the distributor as of December 31, 2016. No revenue is recognized as of December 31, 2016; however, all goods have been transferred to the distributor. Therefore, it is considered a "completed contract," and the entity does not apply the new revenue standard to this contract when it adopts the new revenue standard on January 1, 2017.

View A

23. After adoption of the new revenue standard, the entity should recognize revenue related to this contract as the products are sold through to the end customers during 2017 (based on previous U.S. GAAP). The new revenue standard is applied to all other contracts (new contracts and those that were not completed as of January 1, 2017).

View B

24. Because the contract is considered "completed," the deferred revenue balance should be written-off as part of the cumulative effect adjustment. The entity should not recognize any revenue related to this contract after adoption of the new revenue standard. In effect, such revenue is never recognized by the entity.

Example 2

25. An entity sells a product to a customer for a fixed fee and delivers the product on December 31, 2016. The entity concludes that it is not probable it will collect the fee

from the customer and, therefore, it does not recognize revenue related to the sale (the entity also does not "gross-up" its balance sheet to record accounts receivable and deferred revenue). Revenue under current U.S. GAAP would be recognized on a cash basis of accounting. There are no other explicit or implicit promises included in the contract. Therefore, it is considered a "completed contract" (the entity has transferred all of the goods to the customer), and the entity does not apply the new revenue standard to this contract when it adopts the new revenue standard on January 1, 2017. In March 2017, the entity receives a cash payment from the customer.

View A

26. The entity should continue applying current U.S. GAAP to the contract and recognize revenue as it receives cash from the customer.

View B

27. Because the contract is considered "completed," the entity should not recognize revenue as cash is received. One view is that the entity should record an offset to equity when cash is received after adoption of the new standard.

Appendix A: Relevant Accounting Guidance

28. Subparagraph 606-10-65-1(d) [C3] requires an entity to apply the new revenue standard using one of the following two methods:
    (a) Retrospectively to each prior reporting period presented subject to certain practical expedients provided in the new revenue standard
    (b) Retrospective with the cumulative effect of initially applying the new revenue standard recognized at the date of initial application ('the modified retrospective transition method').
29. Subparagraph 606-10-65-1(h) [C7] states that under the modified retrospective transition method, an entity shall apply the guidance in the new revenue standard retrospectively only to contracts that are not completed contracts at the date of initial application (for example, January 1, 2017, for an entity with a December 31 year-end).
30. Subparagraph 606-10-65-1(c)(2) [C2(b)] defines a completed contract as a contract for which the entity has transferred all of the goods or services identified in accordance with revenue guidance that is in effect before the date of initial application.
31. Paragraph BC441 explains that 'the cumulative effect under the modified retrospective transition method would be an adjustment to the appropriate opening balance of equity in the year of initial application (that is, comparative years would not be restated) for contracts that are not completed at the date of initial application. (The Boards clarified that a completed contract is a contract in which the entity has fully performed in accordance with revenue guidance in effect before the date of initial application. Thus, a completed contract would include a contract for which the entity's performance was complete but there was a change in the transaction price after the date of initial application.)'
32. Paragraph BC444 further explains that 'the Boards also considered other transition methods as alternatives to the modified retrospective transition method to try to ease the burden of retrospective application. For example, the Boards considered requiring a prospective approach that would require entities to apply the new revenue standard only to new contracts or those that are materially modified on or after the date of initial application. However, the Boards rejected this approach because prospective application would not result in consistent presentation of existing contracts and new contracts and thus would reduce comparability. In addition, this approach would not

provide useful trend information for users of financial statements until existing contracts have been fully satisfied after the date of initial application. Furthermore, the Boards observed that this approach would require some entities to incur significant costs of maintaining two accounting systems for contracts that are accounted for in accordance with the new revenue standard and previous revenue guidance in U.S. GAAP or IFRS, until all existing contracts have been completed, which could take many years for entities with long-term contracts.’